

Treasury committee inquiry into inherited estates

April 2008

OFT993

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EXECUTIVE SUMMARY

The Office of Fair Trading (OFT) is responding to an invitation for written evidence issued by the Treasury Select Committee (the TSC) on its inquiry into inherited estates held by life assurance companies' with-profits funds.¹ This paper considers the extent to which the permitted uses of these inherited estates have any adverse effects on competition. We do not consider issues of consumer fairness in the distribution of the estates as it is more appropriate for the Financial Services Authority (FSA) to comment upon these issues.

In drafting this paper we have had a series of discussions with the FSA on factual issues and also received information from Which?. Our analysis draws upon these discussions as well as other information held in the public domain. Given time constraints, we have not consulted industry representatives.

With-profits is the name given to a class of investment products that smoothes out returns on money invested over the period of time the policy is held, limiting returns in years of good investment growth in order to top up returns in less successful years. In addition to the smoothing of benefits, they often offer investors guaranteed minimum payouts from a pooled investment fund.

One of the features of a with-profits fund is the existence of the inherited estate, which is defined as those assets set aside, over and above the fund's realistic liabilities.

The inherited estate consists of working capital which under the FSA definition 'supports the business of the with-profits fund... [and] other uses for the fund such as funding new business'. It is inherited in the sense that it is made up of many generations of policyholder and shareholder contributions.

If in any given year the size of the inherited estate exceeds what a company can justify as necessary working capital to support the fund the surplus is commonly distributed between policyholders and shareholders, in accordance with FSA rules on treating consumers fairly. In some circumstances shareholders may

¹ Treasury Select Committee Press Notice No. 26 issued on 26 February 2008.

choose to carry out a reattribution of the inherited estate whereby policyholders are financially compensated for giving up their interest on it.

This paper considers whether allowing life assurance companies to use their inherited estates to finance new business, make strategic investments, pay shareholder tax and pay the costs of compensation mis-selling is having an adverse effect on competition.

For the purposes of this competition assessment we did not consider it necessary to reach a conclusion on market definition, since the competition assessment is similar whether we consider with-profits and non-with-profits to be in same (wide) or separate (narrow) markets. We noted, however, that the effect on competition could be felt in a separate market for non-with-profits products only, since with-profits firms can also write this type of policies into their with-profits funds.

Taking with-profits policies separately, it is notable that these have significantly fallen in popularity in recent years. They now account for only a very small proportion of all new business written. We note in particular that a number of suppliers have withdrawn their with-profits products altogether. The fall in with-profits policies has been mirrored by a rise in popularity of other similar products. It would appear, therefore, that even if new with-profits policies were being subsidised by inherited estates, in order to curb the decline in sales, for example, that this strategy is not being successful.

Accordingly, in considering the competition impact of the various uses of inherited estates, we believe a more serious concern would be if inherited estates were being used to subsidise the supply of new non-with profits policies. The harm in this case would be that with-profit companies would gain a competitive advantage in the supply of non-with-profits policies (either in a narrow market for these policies only or in a wider market encompassing both types of policies) and prevent other, perhaps more efficient firms, from expanding or entering the market.

Evidence that this was occurring could be if with-profit companies with large inherited estates were holding persistently high shares of new non-with-profits

business in the relevant market(s) and/or, in the absence of other barriers to entry, if we observed little new entry.

We could not obtain share of supply data for the main with-profits companies in the time available, however. Instead, in assessing this theory of harm we tried to examine whether the cost of capital to with-profits firms of using their inherited estates is indeed lower than the cost of capital from alternative sources to non-with-profits companies and new entrants. The available evidence suggests that this is not the case.

First, there are FSA rules on the terms in which new business can be written in a with-profits fund, which raise the cost of using the inherited estates and suggest that the cost of capital to with-profits firms from this source is not significantly different from, at least, the cost of capital to non-with-profits companies, some of which have also retained funds for working capital purposes.

Second, there is evidence that non-with-profits companies have been able to obtain a large share of the new business being written despite not having an inherited estate.

The evidence on entry also does not suggest that it is the inherited estates that are inhibiting entry in the relevant markets: twenty or so years ago, when with-profits business had a much larger market share than it has now, and inherited estates were already substantial, entry did occur. Nothing material seems to have changed since and, if anything, inherited estates have shrunk relative to realistic liabilities.

While there may have been very few new entrants in the last 10 -15 years, this appears to be due to other factors.

Independent research by other parties has revealed that it is difficult for new entrants to establish distribution outlets, which is one reason why in the UK life market new entrants have had only modest levels of sales. It also appears that it is difficult for a new entrant to establish a reputation that will result in high levels of sales from independent financial advisers.

Finally, regarding with-profits products in particular, the fact that consumer interest on these policies is declining appears to be a more significant barrier to entry into the supply of these policies than the existence of inherited estates.

Based on our preliminary analysis it would appear to us that inherited estates and the various uses that with-profits companies make of them do not significantly distort competition in the relevant market, whether the markets are narrow markets for with-profits products and non-with-profit product separately or a wider one encompassing of both types of products.

This conclusion rests on the arguments that (a) the opportunity cost for with-profits companies of using their inherited estate is not different from the opportunity cost of using the capital set aside by non-with-profits competitors and new entrants and (b) that the inherited estates have not increased significantly, nor have regulatory restrictions on their use decreased, from 20 or so years ago, when entry in competition with with-profits companies did occur. We have no evidence to suggest that these arguments are incorrect.

1 ABOUT THE OFFICE OF FAIR TRADING

- 1.1 The Office of Fair Trading (OFT) is the UK's competition and consumer authority. Our mission is to make markets work well for consumers. Our vision is for competitive, efficient, innovative markets where standards of consumer care are high, consumers are empowered and confident about making choices and where businesses comply with consumer and competition laws but are not overburdened by regulation. We adopt a market-informed approach with a focus on outcomes that support productivity growth and consumer and business welfare. We believe this approach is in the best interests of both businesses and consumers as well as to the benefit of the UK economy.
- 1.2 As part of its activities, the OFT monitors the services sector of the economy. This includes financial services such as banking, credit cards, insurance and credit licensing and enforcement.
- 1.3 It is in reference to these activities that the OFT is responding to the Treasury Select Committee's invitation to submit written evidence on inherited estates. The Office has also been approached by the Policyholder Advocate for Norwich Union and by Which? on this matter. As part of the process of writing this paper we have discussed the issues with these parties (and also the FSA) and received evidence.
- 1.4 This paper responds directly to the Select Committee's question of whether allowing with-profits companies to use inherited estates to subsidise corporate activity has any adverse effects on competition. We do not comment on consumer fairness issues as we consider the Financial Services Authority to be best placed to comment on these issues.

2 BACKGROUND

With profits

- 2.1 With-profits is the name given to a class of investment products that smooth out returns on money invested over the period of time the policy is held. With-profits investments can be allied to life assurance, pensions, endowments, bonds or annuities. With-profits funds are pooled investments with funds typically invested in much the same way as other pooled funds.
- 2.2 Clay et al. (2001)² conclude that the typical characteristics of a with-profit product compared to other products are:
- the smoothing of benefits
 - the build up of guarantees over time
 - the fact that, in many cases, the policyholder participates, through the operation of a bonus pool, in the profits and losses of the company.³
- 2.3 Policyholders often receive guaranteed returns in the form of a minimum payout amount, provided the policy is not broken. This minimum amount is supplemented by the payment of additional, discretionary bonuses. Once these bonuses are added they become part of the guaranteed amount, under certain conditions.
- 2.4 Compared to other pooled investment funds, the fundamental difference in with-profits funds is that they often offer policyholders a guaranteed minimum amount, which could be taken to mean that they are a safer

² Clay, G.D. et al. (2001) '*Transparency with-profits – Freedom with publicity*', presented to the Institute of Actuaries on 26 February 2001 and 21 May 2001 and to the Faculty of Actuaries on 19 March 2001.

³ These are very similar to the distinguishing features of with-profits pointed out in the 2002 Sandler Review.

form of investment. The choice for consumers is essentially their appetite for risk.

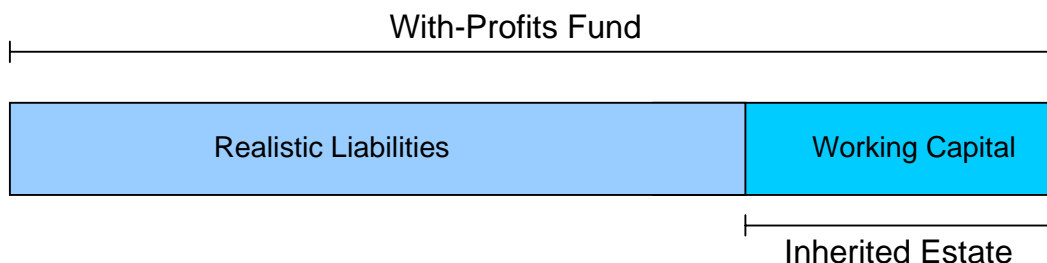
Inherited Estates

- 2.5 A with-profits fund includes assets owned by the company that will be used to meet realistic liabilities to policyholders. The term inherited estate refers to the part of the with-profits fund set aside over and above its realistic liabilities. The estate is inherited in the sense that it contains contributions from the premiums of multiple generations of policyholders. Shareholders may also have contributed to through capital injections.
- 2.6 As stated by the FSA the inherited estate 'provides working capital for the with-profits fund in the longer term and supports its operation'.⁴ The FSA set out the definition of working capital in relation to with-profits products in its Briefing Note BN017/06:
- 2.7 'With-profits funds typically have working capital which is the excess value of assets over and above that needed to cover the current estimated realistic liabilities of each fund. It supports the business of the with-profits fund but can also be put to other uses for the fund such as funding new business. The working capital will have been derived from money paid in by policyholders and shareholders over the years. Once a firm closes for new business it no longer needs working capital to fund new business.'

⁴ FSA, '*The Process for Reattribution of Inherited estates*'

2.8 This is illustrated in Chart 1 below.

Chart 1: The With-Profits Fund



2.9 It is important to stress, therefore, that funds inside the inherited estate are meant for commercial operations and not simply to facilitate a company's smoothing policy. In a 2003 consultation paper, the FSA stated that a with-profits company may retain part of its investment returns, for example, to ensure that it has a strong capital base or so that it can invest in more volatile investments that provide scope for greater long term returns.⁵ The FSA has further clarified that such funds in the inherited estate have been used to:⁶

- provide investment flexibility by enabling a higher proportion of the fund to be invested in more risky assets (such as equities) which have greater potential for yielding higher returns over the long term
- facilitate the smoothing policy of the fund
- provide a cushion against unexpected adverse events
- develop the firm's business, by investing to improve the efficiency or the provision of additional services to customers
- provide capital to support the writing of new business and development of new products.

⁵ FSA Consultation Paper 207 (CP207), '*Treating with-profits policyholders fairly*', at paragraph 5.2.

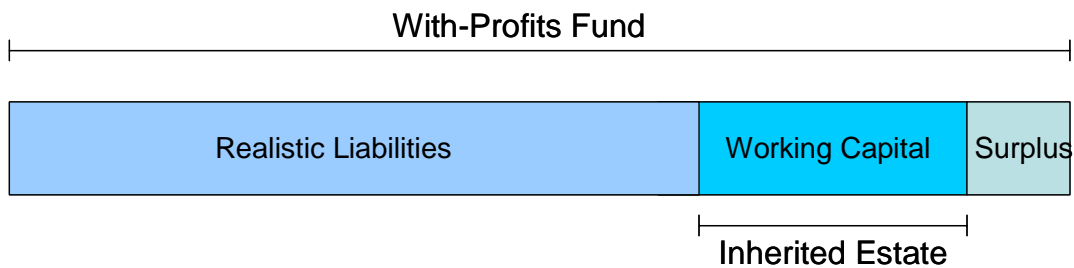
⁶ In its letter to Clare Spottiswoode and Mark Hodges of 6 December 2007.

- 2.10 It follows that in many ways the inherited estate is not different from surplus assets that arise in excess of the amount of policy liabilities that non-with-profits companies retain during the course of their activities. When these companies write new business into their funds, they are able to draw on any surplus assets to provide support in much the same way that inherited estates do in with-profits funds.⁷
- 2.11 It is important to note, however, that there are FSA rules that restrict how the inherited estate can be used. In particular, a with-profits company is required to justify the size of the inherited estate that is required for to support the fund. If its inherited estate exceeds this requirement, the surplus has to be distributed where it would be unfair to policyholders not to do so.

Distribution and reattribution

- 2.12 From time to time, as chart 2 shows, a company might find itself with a surplus over and above what it requires for working capital in a particular year. A surplus may have arisen due to over-cautious actuarial assumptions. The chart below summarises how a surplus relates to a fund's inherited estate and realistic liabilities.

Chart 2: The With-Profits Fund with a Surplus



⁷ This opinion is based on information provided by the FSA, but in the time available we have not verified it with industry participants.

- 2.13 Any surplus arising may be distributed between policyholders and shareholders.⁸ In a 90:10 fund, policyholders receive 90 per cent of the surplus, and shareholders 10 per cent. There is, however, no guarantee that a surplus will arise.
- 2.14 The money allocated for policyholders is then added to their bonuses, while the money allocated for shareholders is removed from the with-profits fund and placed elsewhere. The surplus is spent.
- 2.15 At this stage it is worth noting that the inherited estate itself is the property of the with-profits company. This has been clarified in a number of FSA publications and also its evidence to the Treasury Select Committee of 22 January 2008. In particular, it has been stressed in CP 207 that policyholders do not have a claim on the whole of the inherited estate, but only on distributions arising from it.⁹
- 2.16 While distributions are normally made once a year, a reattribution is much rarer. Reattribution is the term used to describe when a company is able to buy out the contingent interests that policyholders have over the inherited estate. A reattribution occurs when the shareholders of the company compensate the policyholders for giving up their claim on distributions that might occur due to a surplus arising. By accepting financial compensation, policyholders (current and future) give up their claim on distributions arising from the inherited estate. It should be noted that not all reattributions will take place in the same way.
- 2.17 Unlike in the case of distributing the surplus, a reattribution of the inherited estate does not move the money out of the long term fund because the money will still be required for fund support. Only when that money is no longer required (at some point in the future when the fund finally closes) can the inherited estate finally be removed from the long term fund.

⁸ See paragraph 5.4 of CP207. Surpluses can be carried forward undistributed, within reason according to our discussions with the FSA in the course of preparing this paper.

⁹ See paragraphs 5.6 and 5.7 of CP207.

3 COMPETITION ASSESSMENT

Scope of the market

Product scope

- 3.1 When consumers are choosing an investment product, they will seek to choose the product most appropriate to their requirements. Thus, for the purposes of defining the scope of the market what is important is not so much whether there are alternative products that exactly replicate the features of with-profits policies, but rather whether consumers regard there to be other products that are substitutable in meeting their requirements.
- 3.2 As discussed above, one of the main features with-profits policies have *vis-à-vis* other policies is they often guaranteed minimum payment amounts. It is possible that there is a group of consumers for whom these guaranteed minimum payouts and low risk are the most important features of an investment policy. These consumers may choose with-profits products even if there was a small but significant permanent rise in prices even if they offered lower returns over alternative products.
- 3.3 In the time available to us we have not been able to determine whether this is the case or whether such a group of consumers would not be protected by other (marginal) consumers switching away from with-profits and/or choosing non-with-profits products instead.
- 3.4 However, the evidence available to us suggests that for a large proportion of consumers, there are some non-with-profits products that may be a suitable, if not preferred, alternative to with-profits. The most relevant statistics being:¹⁰

¹⁰ Quoted in O'Brien (2007), '*The UK with-profits life insurance industry: a market review*'. Centre for Risk & Insurance Studies, University of Nottingham.

- the new with-profits regular premium business has declined in recent years from £4,108m in 1985 to £295m in 2005
 - in contrast, non-profit business has risen in the same period from £1,062m to £3,723m
 - within the with-profits sector, pensions business has overtaken life assurance as the mainstay.
- 3.5 Data provided by the FSA also shows that the number of new with-profits policyholders in 2006 numbered approximately 340,000 compared with over five million in each of the years 2001 and 1996.¹¹
- 3.6 It appears that consumer interest in with-profits has declined. This may have been for reasons of low returns and low consumer confidence resulting from mis-selling scandals.
- 3.7 It has not been possible in the time available to determine exactly the type of policies that consumers are favouring over with-profits products, but a minimum it could plausibly include unit-linked policies.
- 3.8 Nonetheless, we do not consider it necessary to reach a conclusion on the definition of the market in this case. This is because, as we will demonstrate, our competition assessment is similar whether we consider with-profits and non-with-profits to be in same (wide) or separate (narrow) markets.
- 3.9 As a final point on product market definition, we note that there is a range of different with-profits products available to consumers. Again, we have not considered each sub-market separately as our arguments are likely to be the same for each submarket.

¹¹ These figures may include policy clusters.

Geographic scope

- 3.10 As O'Brien (2007) notes the number of consumers purchasing life assurance from overseas insurers is very small and that there are significant differences between national markets. This implies that overseas insurers will find it extremely difficult to sell in the UK without establishing a presence and obtaining the requisite authorisations.
- 3.11 We agree with this assessment. The geographic scope of the market is therefore likely to be the UK.

Market structure

- 3.12 Given time constraints, we have been unable to obtain data on the wider definition that includes non-with-profits products and on the supply of non-with-profits products separately. However, we do have limited data on the with-profits only market.
- 3.13 The FSA estimates that there are 32 million with-profits policies in open and closed funds in the UK, valued at £432 billion.¹² They also informed us that there are 20 life insurers open to new with-profits business, but in some cases the with-profits business has very limited guarantees (this number of life insurers does not include small friendly societies). A number of traditional with-profits companies are reported to have stopped accepting new business.
- 3.14 The FSA has further reported to us that they are unaware of any new entrants in at least the last five years and that the number of new with-profits policyholders in 2006 numbered approximately 340,000 compared with over five million in each of the years 2001 and 1996. Further, as a proportion of total new business, with-profits has fallen considerably – from 73.2 per cent in 1985 to 4.1 per cent in 2005 (O'Brien, 2007).

¹² In its May 2007 paper, *Insurance Sector Briefing: Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders.*

- 3.15 We also have seen no evidence to suggest that any single company is dominant in the supply of with-profits products, or that a number of companies hold a collective dominant position.
- 3.16 In the wider insurance sector, SynThesys Life data shows that in recent years, the largest two companies, who between them have 25 per cent of new business (measured as regular and single premiums), were Legal and General Assurance (Pensions Management) and Barclays Pension Management.¹³ Neither of these companies offer with-profits products or have inherited estates. The next largest company on this measure is Legal and General Assurance Society, but less than four per cent of its business was in with-profits.

Theory of harm

- 3.17 In this section we consider the competition question raised by the Treasury Committee – namely whether allowing life assurance companies to use inherited estates to finance new business, make strategic investments, pay shareholder tax and pay the costs of compensation mis-selling is having an adverse effect on competition.
- 3.18 In investigating this question the OFT considered the possible effects on competition both in a wide market for with-profits and non-with-profits products and in the supply of with-profits and non-with-profits products separately.
- 3.19 In carrying out our assessment we started by clarifying what is in fact allowed by FSA rules. We then looked at the combined effect of financing all the activities that can be charged to inherited estates on the supply of new policies by with-profits firms (as opposed to looking at each activity in turn). Our assessment is based on our understanding of how the market operates and of the incentives that exist for with-profits firms to behave in a way that distorts competition. The evidence available to support our arguments is included where appropriate.

¹³ This data was provided to us by the FSA.

FSA rules on the use of the inherited estate

- 3.20 Regarding the financing of new business, the FSA explained that the acquisition of new business has an impact on the value of assets in the fund. While new premium payments received have a positive impact, transaction related costs and overhead costs incurred in order to acquire the new business (including marketing costs and the payment of commissions to financial advisers) have a negative impact.
- 3.21 It follows that the net change in assets is unlikely in the short run to be sufficient to cover both the cost of establishing the mathematical reserves as a balance sheet liability and the regulatory capital base that needs to be held in respect to the new business taken on. There is, therefore, a cash flow timing issue.
- 3.22 FSA rules (COBS 20.2.28) allow the inherited estate to be used to address this cash flow issue provided a with-profits company recovers back into the with-profits fund, out of the premiums and charges of the new business written, the acquisition costs it charged to it.
- 3.23 Regarding the use of inherited estates to pay shareholder tax, the argument is that in a 90:10 fund, shareholders incur a corporate tax liability on their 10 per cent share of the funds that are distributed. For new entrants, the FSA would require this tax bill to be paid by shareholders, but for existing with-profits firms the FSA permits this tax bill to be charged to the inherited estate.
- 3.24 The FSA has told us that their rules do not in fact allow this unless it is already an established practice of the firm and which has been disclosed to policyholders (and, in some cases, might be sanctioned by a scheme of financial management approved by the High Court).
- 3.25 The Committee is also inquiring whether allowing with-profits companies to use their inherited estates to make strategic investments and for paying the costs of compensation for mis-selling can have an effect on competition. We note that, with respect to compensation costs for mis-selling, the FSA has confirmed that it will be consulting on this. The FSA also confirmed that with-profits firms are allowed to use their inherited

estates for making strategic investments that strengthen the capital base of the fund. The returns on these investments must be paid back into the fund, however.

- 3.26 Essentially, therefore the inherited estates are used as working capital. Only a small part of it appears to be in fact consumed for these purposes, with the remainder being used as a floating fund.

Theory of harm

The use of inherited estates to subsidise corporate activity, including financing of new business, making strategic investments, paying shareholder tax and paying the costs of compensation for mis-selling , is having a distorting effect on competition in a wide market for with-profits and non-with-profits products or in the supply of with-profits and non-with-profits products separately.

- 3.27 As discussed above inherited estates are used as a source of working capital. In contrast to incumbent with-profits companies, a potential entrant or a non-with-profits company would need to have access to an alternative source of capital to finance the activities that with-profits companies are able to finance with their inherited estates. The argument, however, is that an inherited estate is a source of cheap credit for with-profits companies that own one, and hence serves as a subsidy to the activities of these companies. This in turn provides them with a competitive advantage over their rivals and/or creates a barrier to entry. At the extreme more efficient competitors might leave or never enter the market.
- 3.28 Before we discuss this theory of harm there are a few points of background worth noting.
- 3.29 First, changes to the UK life and pensions market have meant that fewer firms are offering with-profits policies. The cost of providing guarantees on investment policies has risen considerably. This, coupled with deteriorating financial positions of certain insurers, has led to the closure of a number of with-profits schemes. Many firms, including with-profits

firms, have made a strategic decision to focus on non-profit business (mainly unit-linked).¹⁴

- 3.30 Second, with-profits firms can write non-with-profits policies into a with-profits fund. The FSA confirmed that some with-profits funds contain only with-profits business; others contain additional types of non-profits business.
- 3.31 It follows that it is important for the assessment of this theory of harm to be clear on whether we are considering that inherited estates are being used to subsidise new with-profits policies or new non-with profits policies. For clarity, therefore, we have considered two separate versions of the theory of harm.

Theory of harm: version (a)

- 3.32 The first version considers that it is the supply of new with-profits policies that is being subsidised by the inherited estates. The effect of this could be that it creates a barrier to entry into the market for with-profits policies, or that with-profit companies with inherited estates would have a competitive advantage over non-with-profits companies in a wider market, which would be expressed in terms of sales of with-profits policies increasing vis-à-vis sales of non-with-profits policies or perhaps, in the supply of with-profits policies not declining as fast as it would without the subsidy.
- 3.33 The trends in the sales of with-profits policies noted above do not support this version of the theory of harm. If with-profits companies were indeed subsidising new with-profits policies with an aim of gaining market share vis-à-vis the sales of non-with profits policies this is not proving to be a very successful strategy, as sales of with-profits products have declined significantly relative to sales of non-with-profits policies, as mentioned earlier in paragraph 3.4.

¹⁴ The FSA submitted that the most common type of non-profits business is unit linked business which represents by far the greatest proportion of new business now being written. Other types of products being sold in material amounts include annuities and term assurances.

- 3.34 Further, while it is possible that a subsidy could be used to arrest (and reverse) the decline of with-profits policies, we note that it is not entirely obvious why a firm that offers multiple investment products (some of which are experiencing growth) would want to preserve the with-profits market in the face of diminishing customer numbers. The evidence suggests that even if this has been attempted that it has not been successful on the basis that new business in with-profits policies continues to decline (there has been no reversal) and more firms are no longer offering them.
- 3.35 Moreover, the fact that the with-profits market is declining appears to be a more significant barrier to entry into the supply of with-profit policies than the existence of inherited estates. We stress in particular that with-profits companies themselves are withdrawing from with-profits business.

Theory of harm: version (b)

- 3.36 The second version of the theory of harm contends that the inherited estates are being used to subsidise the supply of new non-with profits policies. The harm in this case would be that with-profit companies would gain a competitive advantage in the supply of non-with-profits policies (either in a narrow market for these policies only or in a wider market encompassing both types of policies) and prevent other, perhaps more efficient firms from expanding or entering the market. Indicative evidence that this was occurring could be, for example, if with-profits companies were holding persistently high shares of new non-with-profits business in the relevant markets and/or, in the absence of other barriers to entry, we observed little new entry in competition with with-profits companies.
- 3.37 We were unable in the time available to obtain share of supply data for the main with-profits firms in the non-with-profits sector or in the with- and non-with-profits sectors taken together.
- 3.38 We attempted instead to assess directly whether the cost of capital to with-profits firms of using their inherited estates is lower than the cost

of capital from alternative sources to non-with-profits companies and new entrants. We found some evidence to suggest that this is not the case.

- 3.39 First, as mentioned above in paragraph 2.10, non-with-profits companies may have also retained surplus assets in excess of the amount of their policy liabilities, which can be used for fund management purposes such as cash flow. We considered therefore whether the opportunity cost for with-profits companies of using the inherited estate was lower than the cost for non-with-profits competitors of using their retained surplus assets.
- 3.40 The argument is that the opportunity cost for shareholders of using the inherited estate to fund new business is lower when compared to other sources of capital because the alternative use of this capital would be to distribute it to policyholders on a 90:10 basis. We found two reasons for believing that this is not the case, however.
- 3.41 First, there are FSA rules on the terms on which new business can be written in a with-profits fund, which require that (a) a with-profits company recovers back into the with-profits fund the acquisition costs it charged to it and (b) that new business must only be written on a with-profits fund if it is unlikely to have a material effect on the interests of existing policyholders. These rules suggest that the with-profits firm must aim to pay back into the fund with the new business at least what it would have made if it had, for example, made other strategic investments (which it can do). If policyholders are made worse off by the writing of new business or strategic investments, then this will not be allowed. These rules therefore raise the cost of using the inherited estates and suggest that the cost of capital to with-profits firms from this source is not significantly different from the cost of capital to non-with-profits companies.
- 3.42 Second, according to the FSA, non-with-profits companies have been able to obtain a large share of the new business being written despite not having an inherited estate.

3.43 As mentioned earlier in 3.17, the two firms that have written the largest amounts of new business in the last few years (by some considerable distance) are not involved in with-profits business and do not have inherited estates.

3.44 The evidence on entry also does not suggest that it is the inherited estates that are inhibiting entry in the relevant markets, which in turn suggests that the cost of capital to potential entrants is not significantly higher than the cost to with-profits companies of using their inherited estates.

3.45 The FSA submitted that there have been very few new market entrants in recent years and none, to their knowledge, offering with-profits products.¹⁵ However, looking back 20 or so years when with-profits business had a much larger market share than it has now, and inherited estates were already substantial, entry did occur. According to the FSA, at that time with-profits funds operated in exactly the same way then as they do now, albeit with less regulatory constraints, in using the fund to support writing new business. This, though, did not prevent a significant number of new firms starting up between the late 1960s and the early 1990s. They included, amongst many others:¹⁶

- Abbey Life
- Allied Dunbar (now Zurich)
- Trident Life
- Target Life
- Save and Prosper

¹⁵ O'Brien (2007) mentions that in fact one firm writing with-profits business did enter the market in 1995: Pensions Annuity Friendly Society. This entry was funded with capital provided by a bank and a reinsurer. However, the society demutualised, transferring its business to a proprietary life insurer, Partnership Life, in 2005.

¹⁶ Some of these have since merged with other firms.

- M&G
- Lincoln
- Black Horse Life
- Barclays Life
- Nat West Life
- Halifax Life
- Vanbrugh Life
- Skandia.

3.46 These firms tended not to offer with-profits products to any material extent - mainly because the existence of an established track record was perceived to be an essential marketing requirement. However, some of these firms went on to be successful in selling unit-linked products in competition to with-profits products.

3.47 This suggests that the ability of with-profits firms to use their inherited estates to support new business did not create a serious entry barrier for new non-with-profits firms at that time. Nothing material appears to have changed in this respect since, and if anything inherited estates have shrunk.

3.48 The earliest year for which data on inherited estates is readily available is 1986. In that year, the global inherited estates (that is to say all inherited estates in the UK) were £36 billion. According to the FSA, the equivalent figure in 2006 was approximately £30 billion. However, the size of the inherited estate relative to total mathematical reserves has fallen sharply. In 1986, the inherited estate of £36 billion was against reserves of £50 billion (around 70 per cent). By 2006, this ratio had fallen to under eight per cent (realistic liabilities and current liabilities of around £400 billion). Thus, the size of inherited estates has declined sharply in relative terms.

3.49 In our view, therefore, the fact that there has not been new entry in the last 10 -15 years must be due to other factors. Given the decline in with-profits business sales, the fact that there has been entry in this segment is not surprising. With respect to the life market more generally, O'Brien pointed out that an earlier study (O'Brien (2001)) revealed that it is difficult for new entrants to establish distribution outlets, which is one reason why in the UK life market new entrants have had only modest levels of sales. He also found that it is difficult for a new entrant to establish a reputation that will result in high levels of sales from independent financial advisers.

4 CONCLUSION

- 4.1 Based on this preliminary analysis it would appear to us that inherited estates and the various uses that with-profits companies make of them are not significantly distorting competition in a wide market for with-profits and non-with-profits products or in the supply of with-profits and non-with-profits products separately.
- 4.2 This conclusion rests on the arguments that (a) the opportunity cost for with-profits companies of using their inherited estate is not different from the opportunity cost of using the capital set aside by non-with-profits competitors and (b) that the inherited estates have not increased significantly, nor have regulatory restrictions on their use decreased, from 20 or so years ago, when entry in competition with with-profits companies did occur. We have no evidence to suggest that these arguments are incorrect.